ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
	)	

COMMENTS OF BELL ATLANTIC

Joseph DiBella

Of Counsel
Michael E. Glover

1320 North Courthouse Road
Eighth Floor
Arlington, Virginia 22201
(703) 974-6350

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Summary

The Further Notice proposes an unjustified side-trip to rate-of-return ratemaking in an effort to recapture the productivity gains that the local exchange carriers are entitled to keep under price caps. There is no legal or factual basis for the Commission's proposal to prescribe a major reduction in local switching rates.

As an initial matter, there simply is no justification for establishing a new access charge scheme that substitutes capacity-based charges for today's usage-based local switching rates. The non-traffic-sensitive costs have already been removed from the per-minute local switching rate elements. And, even if this were not the case, the remaining per-minute rate is too small to justify mandating a shift to an entirely new rate structure at this point in the transition to a competitive market.

Regardless of the merits of a capacity-based structure, it cannot be used as the basis for either a prospective or a retroactive reduction in the price cap limits for local switching. Unlike the factor in the common line formula that adjusts the price cap index for the growth in minutes per-line, the Commission's proposal for a similar factor in the traffic sensitive price cap formula cannot be justified by demonstrating that the underlying costs of local switching are non-traffic sensitive. Indeed, the entire justification for capacity based rates is that they might do a better job of reflecting peak *usage*. Moreover, such a factor would double count the calculation of historic productivity that underlies the current 6.5 percent "X-factor." Imposition of this factor, either prospectively or retroactively, without an offsetting reduction in the X-factor,

would unlawfully circumvent the Court's remand of the Commission order adopting the current X-factor.

Rather than emulate the growth factor in the common line price cap formula, the Commission should eliminate it. The Commission has recognized that the "total factor productivity" methodology it used in 1997 to calculate the current 6.5 percent X-factor double counts the effect of the growth factor in the common line formula. Therefore, it should be eliminated prospectively, and the common line price cap should be increased to remove the retroactive effect of this unjustified factor.

The local exchange carriers have not recovered excess revenues as a result of the Commission's decision to shift some of the costs of residential and single-line business lines to the rates for multiline business lines. While the growth rate for multiline business lines is somewhat higher than residential lines, it is not as high as it would be if the Commission had not artificially inflated multiline rates by requiring them to subsidize other lines. Placing the subsidy on the most price-elastic service does not give the price cap carriers a windfall – it reduces their total revenues.

Instead of devising new regulatory schemes that will increase, rather than decrease, the amount of regulation as competition increases, the Commission should reduce the regulatory constraints that limit competition by completing its framework for pricing flexibility. The Commission should allow the local exchange carriers to geographically deaverage their common line and traffic sensitive charges without a competitive showing, and it should adopt Phase II relief for these categories (complete removal from price caps) when carriers can demonstrate competitive alternatives for 50

percent of customer locations or 65 percent of service revenues. In addition, the Commission should allow a carrier to remove all of these services from price caps for its entire region once it has met the Phase II triggers for 85 percent of its revenues in the region.

The Commission also should adopt minimally intrusive rules to prevent price gouging by competitive local exchange carriers for terminating access traffic and for originating toll-free traffic. A simple remedy is to prohibit competitive local exchange carriers from charging more per-minute on terminating traffic than they do on originating traffic, which is subject to competitive pressure. For toll-free calls, they should be prohibited from charging more on originating calls than they do for originating traffic that is not toll free. In both cases, the Commission should ensure that competition works by clarifying the ability of interexchange carriers to decide whether or not they will subscribe to originating access services from competitive local exchange carriers.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	
Access Charge Reform	CC Docket No. 96-262
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1

COMMENTS OF BELL ATLANTIC[1]

The Further Notice's[2] proposal to prescribe a major reduction in local switching rates must be rejected. Despite the Commission's previous conclusion that regulation should be reduced as competition increases, the notice inexplicably proposes to revert to the type of micro-management of access rates that pre-dated price cap regulation. Worse, the proposal to re-price local switching rates as if a capacity-based rate structure had been in effect from the beginning of price caps would double count the effect of the price cap productivity factors and contradict the entire premise of price caps – that the prospect of earning more than the prescribed rate of return would give local exchange carriers an

[1] The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, DC, Inc.; Bell Atlantic-West Virginia, Inc.; New York Telephone Company and New England Telephone and Telegraph Company.

[2] In the Matter of Access Charge Reform, CC Docket No. 96-262, Fifth Report and Order and Further Notice of Proposed Rulemaking, FCC 99-206 (rel. Aug. 27, 1999) ("Order" or "Further Notice").

incentive to exceed the historic productivity growth they had achieved under rate of return.

Rather than engaging in an 11th hour attempt to resurrect rate-of-return, the Commission should reduce the regulatory constraints that limit competition by completing its framework for pricing flexibility. The Commission should allow the local exchange carriers to geographically deaverage their common line and traffic sensitive charges without a competitive showing, and it should adopt Phase II relief for these categories (complete removal from price caps) when carriers can demonstrate competitive alternatives for 50 percent of customer locations or 65 percent of service revenues. The Commission should also adopt minimally intrusive rules to prevent price-gouging by competitive local exchange carriers on terminating access.

I. There Is No Need To Revisit The Rate Structure For Local Switching.

A. There Is No Justification For Imposing A New Capacity-Based Structure For Local Switching.

The Commission asks for comments on a proposal to require the local exchange carriers to adopt capacity-based charges for local switching, to replace the current minute-of-use rate structure. Further Notice, ¶¶ 211-216. There are several reasons why this would be counterproductive, especially at this time. Rather than prescribe a capacity-based rate structure, the Commission should give the carriers the option to shift to such a rate structure, with or without a call setup charge.

First, this attempt to micro-manage access rates is directly contrary to the Commission's market-based approach to access reform and as well as the two phase structure for pricing flexibility that the Commission adopted in the very same order. The Commission correctly has chosen to reduce regulatory restrictions as competition increases, with complete removal of rates from price cap regulation when certain competitive triggers are met. Since the discipline of the market will replace regulation as a control over a carrier's prices, it likewise will provide incentives for the carriers to adopt rate structures that are cost-causative and responsive to customer demand. One of the primary ways that competitors can enhance their market position is by developing innovative pricing plans that meet customer needs. To require a shift to a radically different rate structure at this juncture would disrupt the business plans of both incumbent local exchange carriers and new entrants, and it would inject uncertainty into the market that would hinder the transition to competition.

The market-based approach is especially appropriate for local switching, which is directly subject to competition from competitive local exchange carriers who operate their own switches. In its recent order re-defining the unbundled network elements that incumbent local exchange carriers must make available, the Commission concluded, "in light of competitive deployment of switches in the major urban areas," unbundled local switching need not be made available for larger customers in major urban markets. ***See*** Press Release, Report No. CC 99-41 (issued September 15, 1999), p. 2. As competition increases for switched services, they should be de-regulated, not be subject to even tighter regulatory controls.

Second, this is a solution in search of a problem. Local switching rates have already declined drastically as a result of the restructuring of rates in access charge reform and the continuing effects of the price cap formula. For instance, Bell Atlantic's current local switching rate is only $0.0077 in the Bell Atlantic-north states and $0.0036 in the Bell Atlantic-south states. With the elimination of the interconnection charge and the carrier common line charge, these are essentially all that is left of per-minute rates that were as much as three cents per minute a few years ago. At these rate levels, per-minute local switching charges have little impact on long distance pricing practices, and any incremental benefit from a different rate structure would be minimal.

Third, there is no real benefit to a new rate structure. The purported justification for a capacity-based rate structure is that it would be more cost-causative, because local switching costs are impacted primarily by peak period usage, rather than total usage. ***See*** Further Notice, ¶ 211. In other words, it is a potential substitute for peak/off-peak usage charges. However, a peak/off-peak rate structure is cost effective only if it shifts traffic to off-peak periods, so that additional usage does not require additional switch capacity. Peak usage for each access *customer* may not coincide with the peak for all traffic at a switch. In addition, the peak periods have been changing over the years as the industry has evolved. For instance, evening hours are now peak periods in many residential areas where customers spend hours accessing the Internet. The Commission cannot assume that the off-peak period for an interexchange carrier is also the off-peak period for a particular switch. Accordingly, if an interexchange carrier promoted off-peak usage as measured by *its* system during periods when the local switch was at peak capacity, the

local exchange carrier would have to add capacity (and cost) for no additional revenue. In this manner, interexchange carriers could shift the costs they impose on the network to other users of the switch. Since interstate, interexchange traffic comprises only about 15 percent of the traffic on the local switch, a peak/off-peak rate structure that is limited to the interstate jurisdiction is not likely to optimize use of the switch. Consequently, a capacity-based charge for local switching will not achieve the Commission's goal of encouraging more efficient use of the public switched network.[3]

Nonetheless, the local exchange carriers should have the option of establishing capacity-based charges for local switching. Eventually, local switching rates could go so low as to make it cost-effective to eliminate the measurement and billing of access charges on the basis of minutes and simply charge flat rates. Since the traffic-sensitive costs of the switch include costs that vary with minutes of use as well as costs that are incurred to set up each call, the Commission should allow carriers to maintain call setup charges in addition to capacity-based rates.

B. A Growth Factor In The Price Cap Formula For Local Switching Is Not Justified.

There is no logical connection between the Commission's proposal to adopt a capacity-based rate structure for local switching and its proposal to adopt a per-line growth, or "q," factor in the traffic sensitive price cap formula. ***See*** Further Notice, ¶¶

[3] While the Commission allowed the state commissions, in Section 251 interconnection proceedings, to approve flat-rated charges for unbundled switching, it is noteworthy that the states generally have adhered to the per-minute rate structure. ***See*** Local Competition Order, 11 FCC Rcd 15499 (1996), ¶ 810.

211, 218. The purported analogy to the "g/2" factor in the common line basket does not exist. Regardless of whether the Commission requires, or allows, capacity-based rates for local switching, there is no basis for adjusting the price cap formula downward each year using a "q" factor.

The Commission included a "g/2" factor in the common line price cap formula (representing the growth in minutes per-line, divided by two) because the carrier common line charge is traffic-sensitive (*i.e.*, it is applied based on minutes of use) while common line costs are non-traffic-sensitive. Accordingly, the Commission was concerned that, absent some sort of adjustment factor, the local exchange carriers would gain increased revenues as per-line usage grew, but their costs would not increase proportionately. The Commission decided to adopt a "g/2" factor in the common line formula to share half of this increased revenue per/line with the interexchange carriers.

In contrast, the Commission's discussion of capacity-based rates for local switching makes it clear that the underlying costs are traffic-sensitive. The only justification for mandating a capacity-based rate structure is that it may better reflect the fact that switch capacity is purchased to satisfy the expected level of peak *usage*. ***See*** Further Notice, ¶ 211. Additional peak usage generates additional switch costs. As is explained in the affidavit of William E. Taylor, a capacity based rate structure is merely another mechanism to recover the same traffic-sensitive switch costs on a basis which, in the long run, remain traffic-sensitive. ***See*** Affidavit of William E. Taylor, attached to Comments of United States Telephone Association ("Taylor Affidavit").

The Commission questions whether a "q" factor may be justified on the basis that "an increase in the number of trunks at a switch may not lead to a proportional increase in local switching costs" unless the additional trunks generate enough traffic during peak periods to require an expansion in switch capacity. Further Notice, ¶ 218. However, the Commission's claim that per-trunk rates would do a *better* job of capturing changes in peak capacity argues that it is a more direct measure of changes in traffic-sensitive switch costs. The only way a capacity-based structure could be considered cost-causative is if the Commission assumed that interexchange carriers would purchase trunk capacity based on the ability of those trunks to meet peak demand loads. ***See*** Further Notice, ¶ 211.

The Commission has already gone to great lengths to remove the costs from the switch that are truly non-traffic-sensitive, and to require a rate structure that imposes these costs on the customers who cause them. In the Access Charge Reform order, the Commission required the local exchange carriers to remove the costs of line ports and dedicated trunk ports and to recover these costs from customers on a flat-rated basis. ***See*** Access Charge Reform, 12 FCC Rcd 15982 (1997) ¶¶ 125-29. This was based on the Commission's finding that the costs of line ports and dedicated trunk ports are caused by the customers purchasing them, and that these costs are not affected by the amount of traffic that goes over them. However, there is no basis for characterizing any of the shared switching costs that remain in the per-minute rate structure (the central processor, switching matrix, and shared trunk ports) as non-traffic-sensitive. ***See*** id., ¶ 135. Adoption of a flat-rated rate structure does not magically turn traffic-sensitive costs into

non-traffic sensitive costs. Consequently, regardless of whether these costs are recovered on a per-minute basis or a per-trunk basis, any factor in the price cap formula that would adjust prices downward would fail to track the direct relationship between costs and demand.

Even if the costs recovered through the local switching rate were non-traffic-sensitive (which they are not), a "q" factor could not be justified without a significant reduction in the current 6.5 percent X-factor. As Dr. Taylor explains, the X-factor in place prior to 1997 was based, in part, on the Frentrup-Uretsky study of historical trends in interstate switched access prices from 1984 to 1990. Taylor Affidavit, 17. This study measured productivity trends indirectly by calculating an X-factor that would have produced the same level of rates (including per-minute rates for local switching) as were obtained under rate of return regulation. Even if a particular rate element was applied on a basis that caused revenues to grow faster than costs, this was incorporated into the productivity factor, which adjusts rate levels down to account for impact of that rate element on earnings so as to achieve the authorized rate of return.

Since 1997, the Commission has used a total factor productivity "TFP" method of calculating the X-factor, which captures the ratio of a firm's total output to its total input. ***See*** Price Cap Performance Review, 12 FCC Rcd 16642 (1997). "The output index represents the quantities of goods or services produced, and the input index represents the quantities of capital, labor, and materials used in the production of those goods and services." Id., ¶ 9. Because the output index for telephone companies includes access minutes of use, it incorporates the effect of charging for local switching on a per-minute

basis, regardless of whether the underlying costs (the inputs) are traffic sensitive or non-traffic sensitive.

Under either methodology, the only way that a local exchange carrier could increase its earnings was to "beat" the X-factor by increasing its productivity above the historic growth rate. It would be inconsistent with these methodologies to adopt a "q" factor that would remove the usage-based local switching rate element that produced the high X-factors in the first place. ***See*** Taylor Affidavit, 20.

Adoption of a "q" factor would circumvent the Court's remand of the Commission order adopting the current 6.5% X-factor. In United States Telephone Association v. FCC, 188 F.2d 521 (D.C. Cir. 1999), the D.C. Circuit found that the Commission had failed to justify its finding that there was an upward trend in local exchange carrier productivity growth since price caps began. ***See*** id., slip op. at pp. 7-8. The Commission cannot re-apply the TFP methodology, which takes the previously existing rate structure as a given, and then change that rate structure to reduce the ability of the local exchange carriers to meet the X-factor target. If the Commission does so, a further reduction in the X-factor must be incorporated retroactively as well. Consequently, any tinkering with the traffic sensitive price cap formula would be pointless.

Nor can the Commission link a "q" factor to any changes in the common line "g/2" factor. ***See*** Further Notice, ¶ 220. As explained below, the "g/2" factor in the common line formula double counts the effect of demand in the Commission's "total factor productivity" method of calculating the price cap "X" factor. Consequently, even

though common line costs clearly are non-traffic-sensitive, the "g/2" factor should be eliminated from the common line formula – it should not be imported into the traffic sensitive basket.

C. Retroactive Application Of A Growth Factor For Local Switching Would Be Arbitrary And Capricious.

The Commission also asks whether a "q" factor should be applied retroactively to correct for the "mistake" of not having adopted capacity-based rates and a "q" factor for local switching when price caps began in 1991. ***See*** Further Notice, ¶ 222. This is based on the erroneous conclusion that adoption of a capacity-based rate structure for local switching would prove that "[t]he existing per-minute rate structure provides the incumbent LEC with more revenue whenever per-minute demand increases, regardless of whether the LEC's costs have increased." Id. In fact, it would prove just the opposite. As is demonstrated above, and in Dr. Taylor's analysis, the Commission's proposed justification for a capacity-based rate structure is that it would be a better measure of how peak period demand (*i.e.*, minutes of use at the peak) causes a direct increase in switching costs. A capacity-based rate structure *assumes* (and rightly so) that the costs remaining in the local switching category are traffic sensitive.[4] Accordingly, there is no basis for a downward adjustment in the traffic sensitive price cap index to apply a "q" factor back to the beginning of price caps (or for applying it prospectively).

[4] As Dr. Taylor also points out, the only basis for concluding that local switching costs have not increased proportionately with total minutes of use is if there has been a flattening out of peak usage since price caps was initiated. However, there is no evidence that this has occurred. Taylor Affidavit, 9.

The Commission's analogy (at ¶ 221) to its retroactive correction of the alleged "erroneous" 1984-85 data point in the original X-factor studies is inapposite. Here, there is no "mistake" that needs to be corrected. As we explain above, the Commission's method of calculating the price cap productivity factor inherently takes into account the effect of per-minute rates by developing a higher X-factor than would be produced by flat rates.

The Commission speculates that a difference in the growth rate for minutes and the growth in switching costs could account for the fact that overall earnings of price cap carriers have increased in recent years despite the increases in the X-factor in 1995 and 1997. ***See*** Further Notice, ¶ 222. However, as is explained in Dr. Taylor's affidavit, the interstate rate of return is based on accounting and separations rules that give an inaccurate picture of both the level and growth of local exchange carrier earnings.[5] When accounting earnings are adjusted to approximate economic rates of return, the actual rate

[5] Taylor Affidavit, 13-15. Nor can the Commission base any conclusions on the rates of return that may have been earned in the traffic sensitive basket in particular. The Commission understood from the start that "use of a single productivity offset for all baskets is likely to result in varying basket-by-basket returns, because productivity gains by basket will differ." LEC Price Cap Order, 5 FCC Rcd 6786 (1990), ¶ 151. The Commission also found that rates of return in individual baskets would be misleading, because they would be the product of cost allocation rules. ***See*** id. In fact, returns in the traffic sensitive basket are artificially inflated by factors such as; (1) the targeting of X-factor price reductions to the transport interconnection charge; (2) increases in local traffic due to Internet usage that shift dial equipment minutes, and hence investment, to the intrastate jurisdiction; (3) the transition to dial equipment minutes as an allocator in the early years of price caps, which also reduced investment assigned to the interstate jurisdiction; and (4) the change in the general support facilities separation factor, which moved investment out of local switching and into common line. These factors slowed the reduction in local switching revenues, while also reducing the denominator (investment) in the return-on-investment formula, which tended to increase the traffic sensitive rate of return compared to the returns in other baskets.

of return achieved by the price cap local exchange carriers from 1991 through 1995 was only 8.75 percent. ***See*** Taylor Affidavit, 15. The Commission itself has noted that reduced reliance on accounting rates of return is consistent with the transition to a competitive marketplace. ***See*** Price Cap Performance Review, 12 FCC Rcd 16642 (1997), ¶ 152.

More importantly, growth in earnings provides no basis for revisiting the price cap formula, because higher earnings were not only anticipated under price caps, they were *intended.*[6] Traditional rate-of-return regulation kept a lid on earnings, but provided little incentive for the local exchange companies to become more productive. In adopting price caps, the Commission found that "establishment of an objective productivity hurdle that applies to prices in each year of the plan provides the LECs an incentive to be more productive, since an improved productivity performance above the amount required by the formula permits them to generate and *retain* higher earnings." LEC Price Cap Order, 5 FCC Rcd 6786 (1990), ¶ 47 (emphasis added). In the 1997 price cap review proceeding, the Commission sought to enhance the productivity incentive by eliminating the rule that previously required sharing of earnings above a certain level, finding that "sharing severely blunts the efficiency incentives of price cap regulation by reducing the rewards of LEC efforts and decisions." Price Cap Performance Review, 12 FCC Rcd 16642 (1997), ¶ 148. The D.C. Circuit upheld this decision, accepting the Commission's

[6] ***See*** Access Charge Reform, 12 FCC Rcd 15982 (1997), ¶ 26 ("Price cap carriers whose interstate access charges are set by these pricing rules are permitted to earn returns significantly higher than the prescribed rate of return that incumbent LECs are allowed to earn under cost-of-service rules").

explanation that "[w]hen all profits are taken away, a firm has no incentive to make them." United States Telephone Association v. FCC, 188 F.2d 521 (D.C. Cir. 1999), slip op. at p. 11. Earnings growth shows that price cap regulation works – it is a sign of success, not failure. The Commission cannot ratchet down the price cap formula to recapture earnings growth without repudiating its own justification for adopting the price cap system.

Furthermore, any attempt to calculate what a capacity-based rate level would be today if it had been in effect since 1991 would be futile. There simply is not enough data on trunk and demand quantities to recalculate the price cap index back 9 years as if there were capacity-based rates and a "q" factor during that time period. At the initiation of price caps, transport was still charged on a per-minute of use basis, which means that there were no billing data for transport trunks. More importantly, the per-minute rates for transport encouraged the interexchange carriers to order an excessive number of trunks, since they paid only for the amount of traffic carried. When the Commission restructured local transport rates in 1992 to adopt flat rates for transport, and again in 1997 to eliminate the "unitary" rate structure for tandem-switched transport, interexchange carriers reconfigured their access facilities to eliminate the inefficient over-ordering of facilities. ***See*** Transport Rate Structure and Pricing, 7 FCC Rcd 7006 (1992), ¶ 20; Access Charge Reform, 12 FCC Rcd 15982 (1997), ¶ 176. This caused shifts in demand that had nothing to do with the level of demand or costs for local switching. In addition, changes in rate levels for transport facilities, the establishment of collocation, and numerous other factors influenced the growth rates for trunks over this period. Any

attempt to reset the price cap indexes using the difference in growth rates between minutes and trunks would have no relevance to the either the growth in local switching costs or the productivity gains that the local exchange carriers achieved.

In sum, an attempt to apply a "q" factor retroactively would be arbitrary and capricious. It would not be consistent either with the justification for a capacity-based rate structure or with the underlying nature of local switching costs, which are undeniably traffic sensitive. A "q" factor should not be adopted either retroactively or prospectively.

D. The Commission Should Not Adopt A Capacity-Based Rate Structure For Tandem-Switched Transport.

The Commission questions whether it should adopt a capacity-based rate structure and a "q" factor for tandem-switched transport and tandem switching similar to the proposals for local switching. ***See*** Further Notice, ¶¶ 223-25. Clearly, the answer is no. Tandem-switched transport and tandem switching are shared facilities that are sized to meet demand from all users, including interexchange carriers, competitive local exchange carriers, mobile carriers, and end users. Pursuant to the Commission's Access Reform Order, the local exchange carriers have already removed the non-traffic-sensitive costs from tandem-switched rates and have established flat-rated charges to recover these costs. ***See*** Access Charge Reform, 12 FCC Rcd 15982 (1997), ¶¶ 170-75. The remaining costs clearly are traffic-sensitive, and are driven by all traffic (i.e., minutes-of-use) that is routed through the tandem. The busy hours of the common trunk groups and interoffice facilities connecting the access tandems to each subtending end office switch would have their own busy hours, many of which would not coincide with the busy hour of the

tandem switch. Moreover, the tandem-switched transport market is subject to a high degree of competition from collocated competitive access providers, which reinforces the need to rely on a market-based approach rather than regulatory prescriptions. Accordingly, the Commission should not mandate a change in the tandem-switched transport rate structure, and there is no justification for applying a "q" factor, either prospectively or retroactively.

II. The Common Line Price Cap Formula Should Not Be Changed.

A. The Commission Should Eliminate The Growth Factor In The Common Line Formula.

The Commission asks whether it should change the "g/2" term in the price cap common line formula to a full "g," which would give all of the productivity gains in the common line basket to the interexchange carriers. ***See*** Further Notice, ¶ 227. To the contrary, the Commission should eliminate the "g/2" factor entirely, since it is already included in the X-factor.

As is discussed above, the Commission originally adopted the "g/2" factor because the carrier common line charge is applied on a per-minute basis, but the underlying costs of the common line are non-traffic sensitive, and do not vary as usage per-line increases. This factor lost all justification when the Commission adopted a TFP methodology for measuring the productivity of local exchange carriers, since the TFP methodology accounts for the difference between fixed cost inputs (such as the fixed cost of a common line) and volume-related service outputs (such as access services priced per-

minute of use) by calculating a higher productivity factor.[7] Consequently, rather than moving to a full "g," the Commission should eliminate the existing "g/2" term entirely.

The Commission conceded the double-counting issue when it adopted the TFP methodology;

> In the Price Cap Fourth Further Notice, we noted that using an X-Factor based on TFP in the common line formula might tend to double-count demand growth. We therefore sought comment on whether reliance on TFP would warrant eliminating g/2 from the common line formula. . . . In the Access Reform First Report and Order, we adopt for price cap incumbent LECs a common line rate structure that will recover almost all common line costs through flat charges on subscribers and on IXCs. LECs will phase out the per-minute CCL over a period of one to three years. We also decide to apply to the common line basket the formula that we use for the traffic-sensitive and trunking baskets as soon as the per-minute CCL charge has been phased out. Thus, any double-counting that results from our adoption of a TFP-based X-Factor will be short-lived.[8]

The Commission's observation, in the Further Notice, that the per-minute carrier common line charge has not been eliminated as quickly as it had anticipated, demonstrates that the double-counting has not been "short-lived," and that the price cap carriers are being harmed financially.[9] Therefore, the Commission's previous findings

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[7] ***See*** Taylor Affidavit, 22.

[8] Price Cap Performance Review, 12 FCC Rcd 16642 1997), ¶¶ 169-70.

[9] In fact, only two years after the Commission adopted measures in the Access Reform Order to phase out the per-minute carrier common line charge, Bell Atlantic and most price cap carriers have already eliminated this charge. For all price cap carriers, the carrier common line charge will recover only about 5 percent of common line basket revenues as of November 1, 1999 (or about 2.5 percent of total access revenues). About half of this amount represents the carriers' contributions to the universal service fund, which are likely to be transitioned to end-user charges. However, regardless of how short-lived this charge is, Bell Atlantic and other carriers have suffered the double-counting since the Commission adopted the TFP methodology in 1997.

compel it to eliminate the double-counting either by dropping the "g/2" term, or by reducing the 6.5 percent X-factor. Such a reduction in the X-factor should be retroactive as well as prospective, to give the local exchange carriers back the amounts that have been double-counted in the past as well.

B. The Commission Should Not Revise The Multiline Business PICC Formula.

The Commission also asks whether it should revise the formula for the multiline business presubscribed interexchange carrier charge ("PICC"), which currently recovers the shortfall in PICC rates for primary residential lines and single line business lines, to remove any excess subsidy due to the higher growth rate for multiline business lines. ***See*** Further Notice, ¶¶ 228-33. The Commission provides an example of business lines growing at a 40 percent rate, while residential lines do not grow at all, generating an excess subsidy over time. ***See*** id., ¶ 232. However, this example greatly exaggerates the actual difference in the growth rates between single business lines/primary residential lines and multiline business lines. The actual difference in growth rates is in the single digits. ***See*** Annual Access Tariff Filings, Tariff Review Plan, Form CAP-1. Moreover, this simple example fails to account for the fact that the subsidy suppresses demand for multiline business services by indirectly increasing the costs of long distance services for these customers. Multiline business customers are highly price elastic, because they have alternatives such as special access services, lines offered by competitive local exchange carriers, and private networks. Moreover, they are the targets of intense marketing efforts by competitors due to their large traffic volumes. Economic theory states that increasing

prices for the most price-elastic segment of demand is inefficient and that it reduces total revenues.[10] Consequently, the Commission cannot assume that the local exchange carriers are receiving excess revenues as a result of the subsidy placed on multiline business PICCs. It is more likely that the local exchange carriers are achieving lower overall revenues due to the non-cost based rate structure that the Commission has imposed on their services to large business customers. There is no basis for the Commission's proposed downward adjustment to the common line basket, which would exacerbate the harm caused by non-cost based rates for business customers.

III. The Commission Should Streamline The Price Cap Baskets And Bands.

The Commission asks for comments on placing flat-rated charges and traffic-sensitive charges in separate baskets, to prevent the local exchange carriers from eliminating certain rate elements, such as flat-rated trunk port charges. ***See*** Further Notice, ¶ 234. This would not be an improvement over the existing system, which groups similar services in the same baskets and service categories. In the LEC Price Cap Order, the Commission observed that "by placing services with somewhat similar customer bases, demand characteristics, and technology into a single category, we believe we have struck a better balance between the ratepayer protections we seek in this plan and the limited pricing flexibility we seek to create." LEC Price Cap Order, 5 FCC Rcd 6786 (1990), ¶ 221. The Commission followed this principle in subsequent reorganizations of the price cap system. For instance, in the transport restructure proceeding, the

[10] A. Kahn, Economics of Regulation, Vol. 1.

Commission removed transport services from the traffic sensitive basket and placed them in a combined transport basket that included special access. ***See*** Transport Rate Structure and Pricing, 9 FCC Rcd 615 (1994), ¶ 12. The Commission found that this would provide a rational framework for transport pricing since "special access, entrance facilities, and direct-trunked transport use essentially the same underlying facilities." Id. The proposal to create separate baskets for flat-rated and traffic-sensitive rate elements would mix rates of dissimilar services under a single price cap index, which the Commission has avoided in the past to prevent cross-subsidies between different services. ***See*** LEC Price Cap Order, ¶¶ 198, 210.

The Commission should promote the transition to competitive markets by simplifying the price cap system, rather than continually creating new categories and sub-categories. Bell Atlantic supports the USTA proposal, which would streamline the price cap system and reduce, rather than enlarge, the number of baskets and service categories. ***See*** USTA Comments, CC Docket No. 96-262 (filed Oct. 26, 1998), Attachment G.

IV. Local Exchange Carriers Should Have The Option Of Geographically Deaveraging Common Line And Traffic Sensitive Charges Without A Competitive Showing.

The Commission should permit (but not require) the local exchange carriers to deaverage their common line and traffic sensitive switched access charges without making a competitive showing. Bell Atlantic supports the proposal of the Coalition for Affordable Local and Long Distance Service ("CALLS"), which would link deaveraging

of common line charges to the establishment of zones for unbundled network elements.[11] In recognition of the Commission's previous concerns about the impact on universal service of changes in the level of subscriber line charges, the CALLS plan provides important safeguards. These include; (1) primary residential and single line business subscriber line charges are subject to phased-in caps; (2) multiline business subscriber line charges cannot be below residential subscriber line charges in a given zone; (3) subscriber line charges of a given customer class cannot have a lower price in a higher cost zone than in a lower cost zone; (4) price cap permitted revenues for deaveraged subscriber line charges cannot exceed revenues permitted under price caps for averaged subscriber line charges; (5) a carrier may not deaverage prior to eliminating multiline business presubscribed interexchange carrier charges and the carrier common line charge; and (6) deaveraging is subject to a minimum subscriber line charge for the lowest cost zone. These safeguards would ensure that all customers benefit from deaveraging of subscriber line charges.

The Commission also should permit the local exchange carriers to deaverage their traffic sensitive charges. While switching costs are not as affected by geography as common lines, both are generally higher in low density areas than in high density areas. The Commission's own proposed formula for switching investment in the universal service cost proxy model recognizes that small switches have a significantly higher investment per-line than large switches. ***See*** Forward-Looking Cost Mechanism for High

[11] ***See*** Memorandum in Support of the Coalition for Affordable Local and Long Distance Service Plan (filed Aug. 20, 1999), at 18-21.

Cost Support for Non-Rural LECs, CC Docket No. 97-160, Further Notice of Proposed Rulemaking, FCC 99-120 (rel. May 28, 1999), ¶ 173. The Commission should permit the local exchange carriers to reflect these cost differences in their switching rates.

V. The Commission Should Allow Carriers To Remove Switched Services From Price Caps When There Are Competitive Alternatives For 50% Of Customer Locations Or 65% Of Revenues.

In the Order, the Commission adopted Phase I relief, and a Phase I "trigger," for common line and traffic sensitive services, that was similar to the Phase I mechanism for dedicated transport and special access. ***See*** Order, ¶¶ 108-122. In both cases, the Commission allowed price cap local exchange carriers to offer volume and term discounts and contract tariffs when competitors achieve a presence in 15 percent of the market.[12] In the Further Notice, the Commission asks for comments on the Phase II flexibility for common line and traffic sensitive services. ***See*** id., ¶ 200.

The clear choice is to parallel the Phase II mechanism for dedicated transport and special access. In Phase II, incumbent local exchange carriers should be permitted to remove common line and traffic sensitive services from price caps when competitors

[12] In the case of dedicated transport and special access (except for channel terminations to end users), Phase I relief applies when competitive transport is offered in 15 percent of the wire centers in a metropolitan statistical area. For common line and traffic sensitive services, Phase I applies when competitors offer services over their own facilities to at least 15 percent of incumbent local exchange carrier customers in a metropolitan statistical area.

offer such services to 50 percent of customer locations over their own facilities.[13] This would represent a "significant market presence" and an "irreversible investment" by competitors that would make further rate regulation unnecessary. Id., ¶¶ 69, 142.

As in Phase II for transport, the Commission also should adopt an alternative revenue trigger for Phase II for common line and traffic sensitive. Phase II should apply if an incumbent local exchange carrier can show that competitors offer common line/traffic sensitive services to customers representing 65 percent of more of the incumbent's revenues from these services in a metropolitan statistical area. This would recognize, as the Commission noted for transport, that demand may be concentrated in a small portion of customer locations. ***See*** Order, ¶ 149. This is especially likely in the common line and traffic sensitive markets, where competitors can put pressure on a large portion of the market by targeting customers with high usage. When competitors have invested in facilities that can serve 65 percent of a local exchange carrier's revenues, there is sufficient market discipline to allow the local exchange carriers to remove these services from price caps.

The Commission also asks whether it should exclude customer locations served by mobile wireless competitors from the Phase II trigger. ***See*** Further Notice, ¶ 202.

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[13] The Commission also should permit showings based on the class of customer served. This would allow carriers the opportunity to address the fact that competitors often target business customers when entering a new market. Since the number of business locations may be a relatively small percentage of total customer locations in a metropolitan statistical area, a local exchange carrier conceivably could lose all of its business customers before obtaining Phase II relief if it was required to show that fifty percent of its total customer locations were offered service by competitors.

Since mobile wireless is a swiftly growing industry, with wireless rates rapidly becoming competitive with rates for wireline services, it will become increasingly important to include some wireless demand in the Phase II trigger.[14] As noted in a recent edition of The Economist, "Many people in the wireless business are convinced that it is only a matter of time before the term "mobile phone" becomes redundant, because there will be no other sort around." Cutting the Cord, The Economist, Oct. 9-15, 1999, p. 12. The Commission's recent order on reporting of competitive information notes that "mobile wireless services have the potential to become significant substitutes for local exchange services offered by incumbent LECs." Local Competition and Broadband Reporting, CC Docket No. 99-301 (rel. Oct. 22, 1999), ¶ 28. Carriers should be permitted to demonstrate how mobile services are a practical substitute for service to customer locations within the areas where they are seeking Phase II relief.

In addition, the Commission should allow Phase II relief for all services in an entire region when the number of areas where a carrier has met the Phase II triggers has reached a critical mass. Once an incumbent local exchange carrier has met the Phase II triggers in areas representing 85 percent of its total revenues, competition is sufficiently widespread that all services should be removed from price caps throughout the region. At

[14] For example, AT&T offers a wireless Family Plan that provides unlimited free calling among up to five family members within a service area that can include portions of several states. AT&T also offers Digital One rate plans with per-minute rates for long distance wireless calls as low as $0.11. Many other wireless carriers also offer blocks of usage as low as $.10 per minute. At these low rates, wireless services become a practical alternative to wireline services. In fact, wireless carriers are already urging customers to "make your wireless phone your only phone." ***See, e.g.,*** ad for AT&T Digital OneRate, New York Times, Apr. 5, 1999, at A11.

that level of competitive penetration, the incumbent local exchange carrier will feel competitive pressure throughout its territory, and any effort to charge unreasonable prices in the isolated areas that have not reached the Phase II level would only accelerate competitive entry. A local exchange carrier would have to develop region-wide pricing plans for its common line and traffic sensitive access services that would compete with similarly wide-spread offerings from competitors. At that point, the best way to promote competition would be to remove all of a carrier's services from price caps.

VI. The Commission Should Adopt Minimally Intrusive Rules To Prevent Price Gouging By Competitive Local Exchange Carriers.

The Commission asks for comments on a continuing problem – the efforts by some competitive local exchange carriers to impose excessive access charges on interexchange carriers by invoking the filed rate doctrine. ***See*** Further Notice, ¶¶ 239-57. Since the Commission has classified the competitive local exchange carriers as non-dominant, they enjoy *carte blanche* to file any rates they choose, and those tariffed rates have the force of law. Some competitive local exchange carriers apparently have chosen to abuse this freedom by basing their business plans on price gouging the interexchange carriers, much as some have designed their business plans around generating excessive reciprocal compensation payments from the local exchange carriers.[15] Such stratagems

[15] AT&T alleges that a number of competitive local exchange carriers impose charges that are as much as twenty times higher than those charged by the incumbent local exchange carriers. ***See*** Order, n.579. Similarly, some competitive local exchange carriers who provide connections to Internet service providers have encouraged customers to keep their lines open twenty four hours a day, for months on end, simply to generate huge (and completely unwarranted) reciprocal compensation payments. Many competitive local exchange carriers obtain 70 percent or more of their revenues

work when the competitive local exchange carrier's end user does not pay for the call, as in a terminating interexchange call or an originating toll free (800 or 888) call, forcing the interexchange carrier to recover the excessive charges from other customers (or its own shareholders).

These schemes are an artifice of regulation – they could not exist in a competitive market where business is conducted under voluntary contractual arrangements. The competitive local exchange carriers rely on Section 201 of the Act, which imposes an obligation on common carriers to establish physical connections with other carriers, to insist that interexchange carriers take their traffic at inflated rates, and Section 203 puts the force of law behind whatever rates a competitive local exchange carrier chooses to include in its tariffs. Of course, the Act also provides that those rates must be just and reasonable, and it gives the Commission power to find unreasonable rates unlawful, and to prescribe reasonable rates. ***See*** 47 U.S.C. §§ 204, 205. Customers also may file Section 208 complaints to object to excessive rates.

While it is not clear that there is a pervasive problem that needs Commission intervention, the Commission could adopt minimally intrusive regulations that would deal with any such abuses without requiring full-blown rate cases.

For originating access services, an interexchange carrier has bargaining leverage with a competitive local exchange carrier, since the interexchange must affirmatively

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from reciprocal compensation, making it clear that their business plans are based not on providing services to customers, but on obtaining subsidies from the incumbent local exchange carriers. ***See*** Reciprocal Compensation Takes Higher Profile With CLECs, Communications Daily, Aug. 5, 1999.

purchase originating access services and arrange trunk connections. The interexchange carrier also may be able to pass along excessive access charges to the competitive local exchange carrier's end user through the carrier's rates for long distance services. Therefore, interexchange carriers have the ability to avoid incurring excessive access charges on originating calls. However, to ensure that the market can effectively discipline originating access charges, the Commission should make it clear that an interexchange carrier need not accept traffic from a switch where it has not purchased originating access services, regardless of whether that switch is connected to an access tandem at which the interexchange carrier receives traffic.

For terminating access services, the interexchange carrier has no such self-help measures, since the called party does not pay the interexchange carrier for the call, and presubscription does not apply on the terminating end. Interexchange carriers have focused on terminating traffic as the primary area where they allege that the market is failing to control the access rates charged by competitive local exchange carriers. ***See*** Further Notice, ¶ 186. The Commission could adopt a simple rule that a competitive local exchange carrier may not impose higher terminating access charges than it applies in the same exchange to originating traffic. ***See*** id., ¶ 253. Since access services are competitive on the originating end, this would allow the discipline of the market to control rates at the terminating end as well. A competitive local exchange carrier that offered excessive originating rates would only discourage interexchange carriers from offering its customers attractive rates, and customers could switch to other carriers offering local exchange services.

For calls where the called party pays, such as 800 and 888 calls, the Commission could establish similar rules on the "open" end (i.e., the originating end). A competitive local exchange carrier could be prohibited from charging higher originating access charges on such calls than it charges for originating calls that are not 800 or 888 calls.

The Commission should make it clear that an interexchange carrier that "owns" the 800 or 888 number is the customer for originating access services on calls to these numbers. In some instances, competitive local exchange carriers have attempted to interpose themselves between an incumbent local exchange carrier's customer and an interexchange carrier on toll-free calls, with the intent of siphoning off traffic and imposing excessive access charges on the interexchange carrier. The Commission should ensure that competition works by clarifying that the interexchange carrier cannot be forced to accept originating traffic on toll-free calls from competitive local exchange carriers that do not provide local service directly to an end user.

VII. Conclusion

The Commission should adhere to its market-based approach to access reform by adopting reasonable standards for Phase II relief in common line and traffic sensitive services, and by avoiding counter-productive regulatory prescription of traffic sensitive rates.

Respectfully submitted,

By: _____
Joseph DiBella

1320 North Court House Road
Eighth Floor
Arlington, VA 22201
(703) 974-6350

Attorney for the Bell Atlantic
telephone companies

Of Counsel
Michael E. Glover

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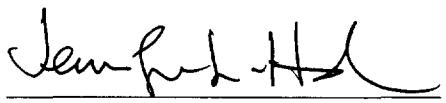
CERTIFICATE OF SERVICE

I hereby certify that on this 29th day of October, 1999, copies of the foregoing "Comments" were sent by first class mail, postage prepaid, to the parties on the attached list.



Jennifer L. Hoh

* Via hand delivery.

Magalie Roman Salas*
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

ITS*